DISTRIBUTION IN CHINA

THE END OF THE BEGINNING

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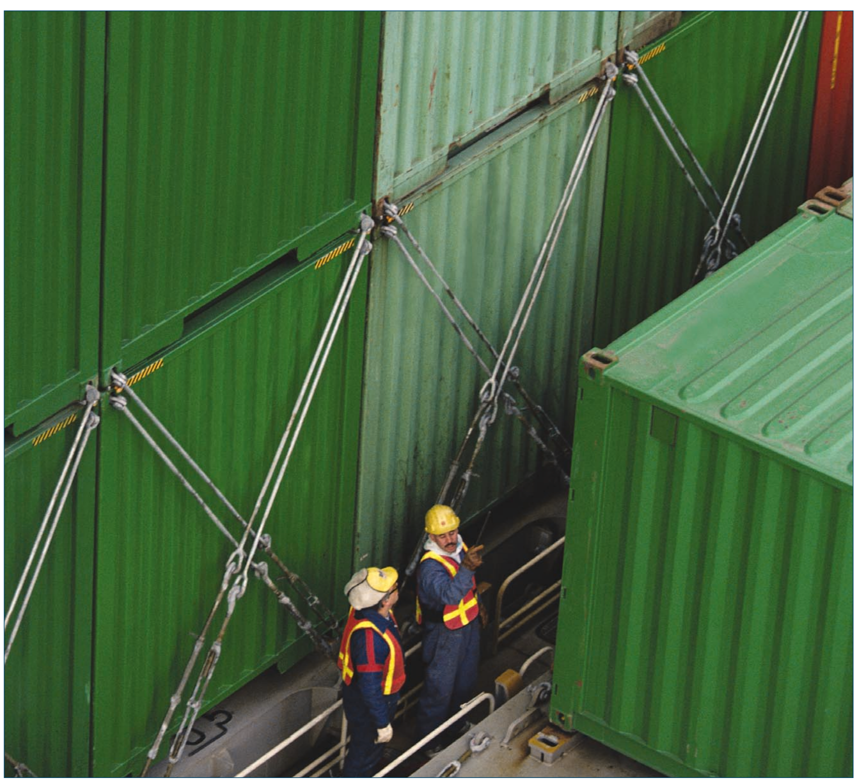
With China's accession to the World Trade Organization (WTO) imminent, the Holy Grail of distribution and trading rights is almost within reach for foreign firms in China. Getting to this point has been neither easy nor inexpensive. Since the opening of China's markets in 1979, the history of distribution in China has been fraught with infrastructure problems and difficult legal issues and many firms have been forced by those circumstances to use highly creative methods to bypass anachronistic and restrictive regulations in order to distribute their products.

Now that greater market access beckons, it is important for businesses to look back at the history of distribution in China to keep a sense of perspective on what changes new market access opportunities will bring under the WTO regime. The underlying trend of the past 20 years is one of centrifugal force — as trading volume and opportunities have expanded, local and foreign firms have pushed the limits of existing trading regulations outward. This, in turn, has forced the government, directly or otherwise, gradually to liberalize the trade regime to reflect market conditions. From that perspective, accession to the WTO is simply the next evolutionary step in the reform and development of China's economy.



In the earliest days of China trade, professional distribution options were scarce. Maoist doctrine encouraged each province and city to be self-reliant, which created considerable industrial overcapacity, few logistical synergies and a vast bureaucracy. Foreign firms had little choice but to use state distribution networks, which were organized along rigid vertical command-and-control lines.

As China's trade with the outside world grew, leaders recognized the need to liberalize this system. When the central government wants to liberalize or reform a particular policy, the most common practice is to implement the policy in measured, calculated steps — in order to evaluate what elements of the policy are and are not working at each step. As control during the 1980s continued to shift away from the center to the provinces and municipalities

Competition among state and provincial firms began to intensify and as a consequence direct state control of imports began to break down. Legally ambiguous ("gray") import channels sprang up; in many cases involving non-civilian work units and an entire industry of these so-called "converters" began to emerge along a Hong Kong-Guangdong axis.

In the mid-1990s, as business volumes grew, foreign-invested enterprises (FIEs) increasingly despaired over prohibitions on sales of goods not manufactured in China and the problems involved in selling their products on a national basis. Some of the key issues then and now, included the inadequate state of transport infrastructure (despite progress in the past few years) made worse by monopolistic practices; a fragmented and chaotic distribution system; and local protectionism. Compounding these difficulties were (and still are) a general lack of professional third-party distribution channels; pricing issues cash flow and accounts receivable problems; the high cost of building and maintaining distribution networks; and the usual petty bureaucratic interference frequently encountered in the PRC commercial environment.

In spite of the difficulties of conducting one's own logistics and distribution activities in China, contrary to popular belief a majority of the foreign companies operating in the PRC are in the black, although perhaps not to the degree they would be if they were able to reduce costs by fully integrating their operations. In fact, many foreign firms have managed to set up national distribution channels and are well positioned to compete in a post-WTO China. Yet most of those same firms have to use a complex array of channels to fulfill their distribution needs and find it difficult to consolidate to take advantage of economies of scale.

Upon accession, a likely outcome for the distribution sector will resemble the historical pattern of evolutionary opening rather than immediate, revolutionary, change. Since both Chinese and foreign firms have the same logistics and distribution problems, they will exert significant competitive pressure on local distributors and service providers to improve their existing business models and force increased integration in the value chain. The result will probably be industry consolidation and introduction of more professional service providers — the majority of which will likely be located in the provinces and may partner with others in neighboring regions. Nationwide, the larger foreign operators will also play a greater role, but they will only be able to benefit fully from WTO terms after three to four years.

The Chinese logistics industry is underdeveloped and historically prone to local protectionism, unfair competition and an excessive number government-related operators who enjoy the privileges of monopolistic regulations at either the national or provincial level.

Leaders in the Chinese logistics industry believe that they have a three- to four-year window in which to restructure their firms and the industry before — as mentioned above — foreign operators become significant competitors. On the other hand, their customers would rather see the industry opened up as soon as possible, because history has shown that the earlier an industry opens up in China, the more it prospers; witness, for example, the strength of the consumer goods and household appliance markets in China today. These were the first markets opened significantly to foreign competition in the 1980s.

Although the WTO will open up many markets in China, distribution and logistics, like other sectors, will no doubt experience implementation difficulties and delays. Foreign firms would do well to remember this fact as they attempt to broaden their distribution networks. But anyone who visited China before 1990 will remember what China didn't have — which was just about everything in terms of business infrastructure and products. Today China has brought itself to the point (in many cases using foreign funds or technology) where, the usual litany of problems aside, the country has a strong foundation from which to develop into a modern economy.

WTO accession marks what historians may remember as the end of modern China's economic beginning. Giving foreign firms the right to operate freely in China is for the leadership a very serious and sensitive matter that it discusses in a historical framework, specifically the pre-liberation period when foreign companies were dominant players in distribution. Since 1979 China's leaders have dealt with this subject very cautiously and have now decided, perhaps reluctantly, that is in China's best interests to allow significant foreign access to the distribution sector, among others.

That is what the WTO is really all about from the PRC perspective — it is not so much about free trade as it is about the need to develop a professional financial and managerial culture based on internationally accepted commercial practices and rule of law so that the country can prosper in the years ahead.

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